Iran war has caused lasting damage to the dollar system

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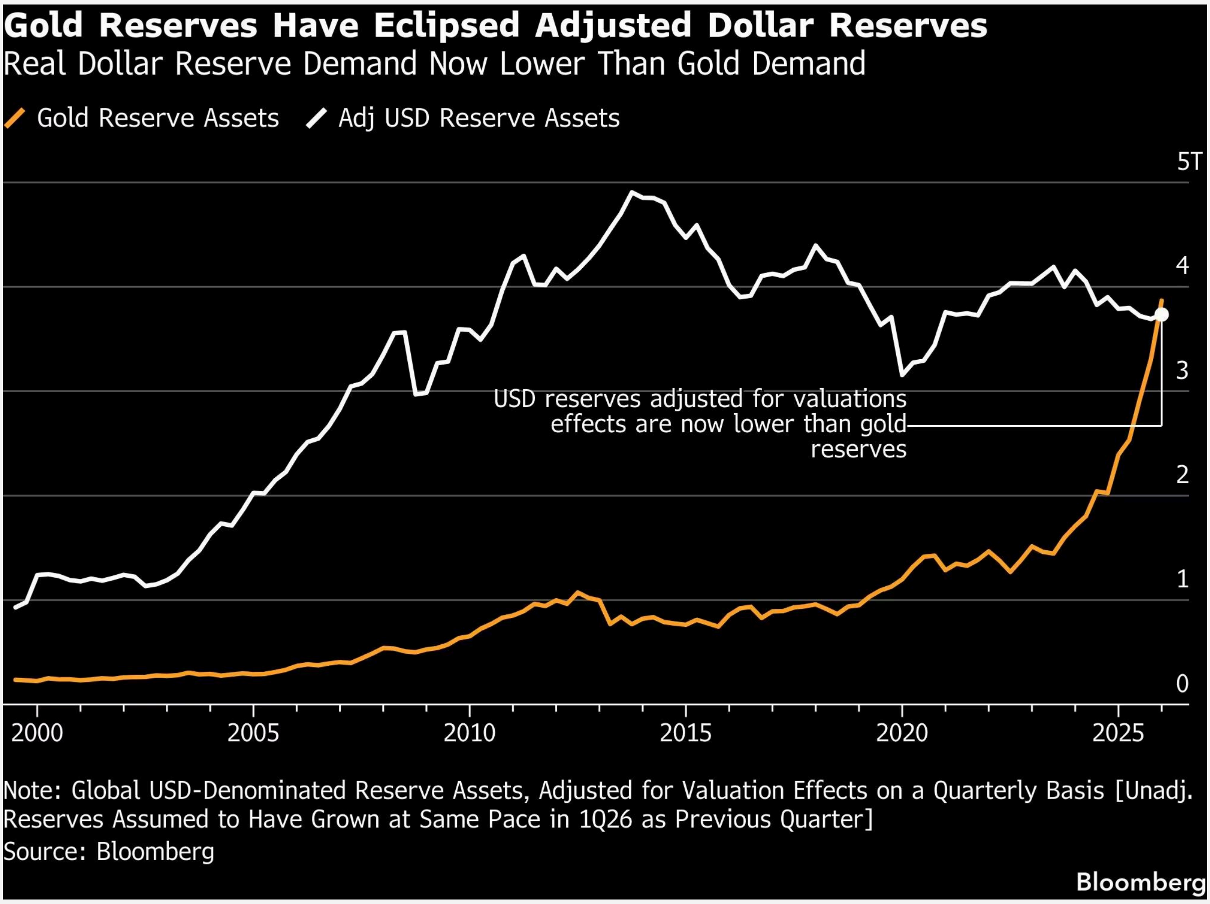
The US’s war with Iran has put a potentially irreversible strain on the global trading system, with gold reserves having eclipsed central bank holdings of valuation adjusted dollar assets for the first time in several decades.

It’s very early days after the announcement of a ceasefire between the US and Iran, yet even if it holds, the conflict is likely to have created lasting effects on the dollar system as President Donald Trump appears to rip up the rules-based order in place since World War II.

The dollar’s demise has been greatly exaggerated on many previous occasions. But it will not be a dramatic point-in-time event. Sterling’s fading as a reserve currency was punctuated by several milestones over an extended period — the end of World War I, coming off the Gold Standard, Bretton Woods and the Suez crisis.

After the increasing weaponization of the dollar, culminating in the seizure of Russian assets in the wake of the war in Ukraine, and the mooting of a Mar-a-Lago accord, the US currency has just passed another milestone in its declining dominance.

Dollar-denominated reserves - ie central bank holdings - adjusted for valuation effects are now lower than gold reserves for the first time since the International Monetary Fund started publishing the data in the late 1990s.



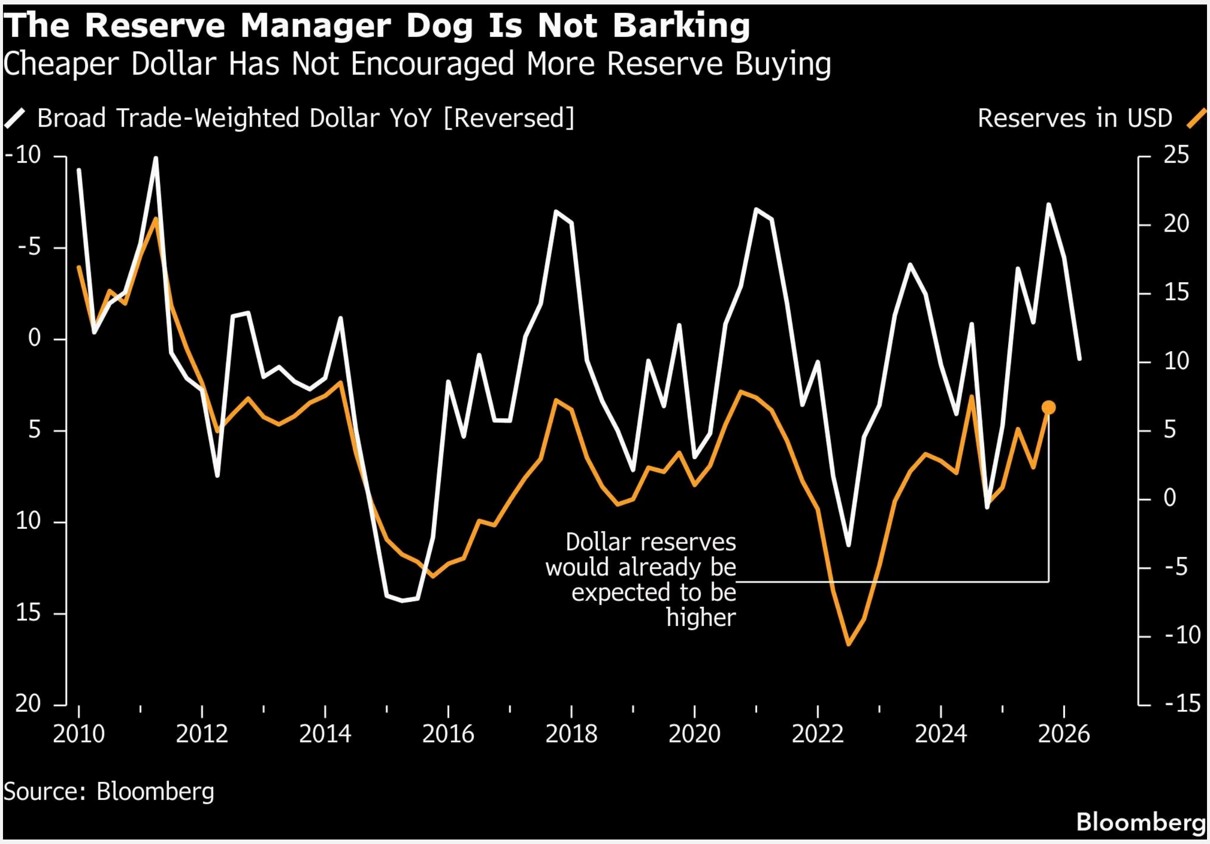
Pairing the unadjusted dollar number with gold as is usually done is not a fair parallel as bullion pays no interest. A more equal comparison is with the dollar shorn of its earning effect, as in the chart above.

Unadjusted dollar reserves then come to about $4 trillion, barely half the $7.5 trillion for the unadjusted measure reported by the IMF, which includes the interest earned on them (I use the Bloomberg US Treasury Index and take its return out of the unadjusted number). The IMF-reported amount is real, but it doesn't capture active demand.

The same argument can be leveled at gold. Holdings of central banks could simply be passively benefiting from the metal's historic rise in recent years. But if we consider the adjusted value of dollar reserves as the currency's "weight," then it has fallen 15% since official holdings of the US currency peaked around 2014. Whereas (almost exclusively emerging markets) central banks have increased their physical holdings of bullion, in tons, by 15%. It's thus hard to refute that actual demand for dollars has been materially softening.

The market has re-alighted on the age-old solution of gold as unimpeachable global collateral — to the detriment of the US currency — after growing distrust in the dollar standard and a lack of viable alternatives to assets separate from the financial system.

We can see it in the changing behavior of global central banks. Until the seizure of Russia's assets, they were opportunistic traders of dollars, buying them when the currency fell, and selling them after it had rallied. No longer. The exchange-rate decline in the dollar in recent years has not been met by meaningful purchases.



But it's more than the changing preferences central banks. Pressures on the dollar system are also coming from higher energy prices and ongoing supply constraints. Oil and gas prices are significantly lower after the ceasefire announcement, but are still much higher than they were before the war. That is putting increased strain on energy importers to raise dollars by liquidating assets.

Further, energy exporters unable to sell their product have been facing their own cashflow pressures. Together, these dynamics led to gold and Treasuries rallying when tensions eased and vice versa.

However, there's a much deeper and long-lasting issue. The quid pro quo that forms the backbone of the global monetary system — that trade proceeds are recycled into dollar assets, allowing the US to fund cheaply, in return for security guarantees and the stability of the global system — can no longer be taken as read.

Normally we would expect that as the Strait of Hormuz is fully re-opened, dollars should eventually flow back to oil exporters, who in turn should buy Treasuries or other US assets. Similarly, as oil prices normalize and importers get back on their feet, they'll eventually have surplus dollars to reinvest in the US.

That can no longer be assumed though. First, when it comes to Middle Eastern exporters such as Saudi Arabia, they have less excess savings to recycle as their economies diversify and invest more domestically.

But it's more critical than that. If the US is no longer seen as reliable a guarantor of stability and security, then there is a diminishing incentive to trade in dollars and recycle them back into the US. The dollar carousel that has underpinned the global monetary system is coming under increasingly grave strain.

As stated, this is not an overnight phenomenon. A current lack of alternative reserve and financing assets ensures that, but that doesn't mean there isn't a puncture and the air won't continue to escape

Gold's ascendancy is but one warning, but others are getting louder. Global trade in dollars has fallen to around 40% in the last few years while that in euros and the yuan has picked up; dollar-denominated international loans have slipped back to 60% of the global total; central bank holdings of Treasuries are now less than their holdings of gold; and the dollar as a share of global FX and gold central bank holdings is falling rapidly.

Common knowledge is often what it to takes to upset accepted norms and overturn ingrained thinking patterns. After the unilateral actions of the US in the Iran war, everyone now knows that everyone knows the rules of the game have changed.

Owning fewer dollar assets becomes increasingly logical. Now that is common knowledge, it’s hard not to see the dollar’s dominance continuing to ebb away over time, and gold’s fortunes further revived.